United States Court of Appeals

for the Second Circuit

APPELLANT'S REPLY BRIEF

ORIGINAL

75-4123 75-4201

United States Court of Appeals

For the Second Circuit

No. 75-4123

IRWIN C. GUILD and BERNICE GUILD,

Appellants-Cross-Appellees,

v.

COMMISSIONER OF INTERNAL REVENUE,

Appellee-Cross-Appellant.

No. 75-4201

JONATHAN LOGAN, INC.,

Appellee,

v.

COMMISSIONER OF INTERNAL REVENUE,

Appellant.

REPLY BRIEF FOR APPELLANTS GUILD

BRAUNER BARON ROSENZWEIG & KLIGLER, Esqs.
Attorneys for Irwin C. Guild and Bernice Guild, Appellants-Cross-Appellees (No. 75-4123)
120 Broadway
New York, New York 10005
(212) 732-5535

ELIAS ROSENZWEIG
STANLEY M. KLEIN
MARTIN B. FARBER
Attorneys

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Table of Contents

Citations

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

IRWIN C. GUILD and BERNICE GUILD, Appellants-Cross Appellees,	:	
v.	:	Docket No. 75-4123
COMMISSIONER OF INTERNAL REVENUE, Appellee-Cross Appellant.	:	
JONATHAN LOGAN, INC., Appellee,	:	
v.	:	Docket No. 75-4201
COMMISSIONER OF INTERNAL REVENUE, Appellant.	:	

REPLY BRIEF FOR APPELLANTS IRWIN C. GUILD and BERNICE GUILD

ARGUMENT

I.

THE DECISION BELOW WAS PREMISED ON A CLEARLY ERRONEOUS CONSTRUCTION OF THE SETTLEMENT AGREEMENT BETWEEN GUILD AND LOGAN

"When I use a word," Humpty-Dumpty said, "it means just what I choose it to mean - neither more nor less".

Lewis Carroll, Alice's Adventures in Wonderland, Chapter 6.

The Settlement Agreement between the parties (92a) contains two sentences wherein are set forth the substance of the agreement as follows:

> "You (i.e., Guild) attempted further to exercise the option with respect to the remaining 15,000 shares, but your right to do so was questioned by us.
>
> We do hereby recognize your right to 6500 shares of our stock upon the terms and conditions of the option".

The only inferences which may logically be drawn from the sentences above quoted are that Logan conceded (1) that Guild had contended that he had options on a balance of 15,000 shares, and that he had attempted to exercise the options which he thought he had, and (2) that Logan, which had initially questioned Guild's right to exercise any options, conceded that he was entitled to 6500 option shares.

In the face of Logan's admission and Guild's testimony (132a) of his attempt to exercise his option, the decision of the Tax Court is clearly erroneous in holding (52a) that Guild failed to exercise the option because he did not comply with the formalities of exercise specified in the stock option agreement.

It is quite beside the point to say, as the Tax Court said, that the formalities of exercise specified in the Stock Option Agreement were not observed in the face of Logan's concession that Guild attempted to exercise his option but was prevented from doing so by Logan's anticipatory refusal

to recognize that he had any rights to exercise. Logan's concession in the Settlement Agreement of Guild's attempt to exercise his option means, quite simply, that Logan understood full well that Guild, in his conversation with Schwartz, Logan's president, was attempting to obtain the option shares to which he claimed to be entitled and was prepared and ready then and there to pay for them (132a). That Logan in conceding that Guild attempted to exercise his option thereby waived formalities upon which it could have insisted is of no consequence whatever for the waiver of these formalities* could not constitute a modification under Section 425(h)(3) of the Code.

There having been an exercise (or at least a frustrated attempt) the only remaining question is whether there was an option to be exercised.

Here again the Humpty-Dumpty approach is manifested. "Recognition" of Guild's option rights by the Settlement Agreement does not mean, as the dictionary would have it mean (see our principal brief, p. 19a), that Guild's pre-existing option rights were admitted or acknowledged; rather it means that rights which theretofore had no existence have been

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* i.e., Written (as against oral) notice and certified (as against uncertified) funds, neither of which had been insisted upon in the case of earlier exercises.

created. Is it not clearly erroneous to give the words which the parties used a meaning not found in any dictionary notwithstanding that the record is devoid of any proof that the word was not intended to have its normal meaning. Logan says in brief (p. 14, footnote 11) that our definition is but one of some twenty listed in the dictionary, but strangely quotes not a single other definition which would be at odds with ours and also useable in the context of the Settlement Agreement.

Commissioner v. Duberstein, 363 U.S. 278 (1960) teaches that a decision is clearly erroneous when it is contrary to the reasonable inferences to be drawn from the undisputed evidence. The undisputed evidence of the Settlement Agreement supports only the conclusions that Guild had option rights and attempted to exercise them. Since these are the ultimate facts established by the record, it follows that Logan's belated acknowledgement of these facts cannot operate to deprive Guild of the benefit of Section 421's non-recognition provisions.

II.

IF IT BE FOUND THAT LOGAN ACCELERATED GUILD'S OPTION RIGHTS, SUCH ACCELERATION DID NOT CONSTITUTE A MODIFICATION UNDER SECTION 425(h) OF THE CODE.

The Commissioner and Logan have each put forward specious arguments that an acceleration by Logan of Guild's option rights would constitute a modification under Section

425(h) of the Code. Building on this erroneous hypothesis they say that a modification constitutes the grant of a new option; and that since the new option would have been granted after January 1, 1954, its provisions would not have satisfied the Code requirements applicable to statutory options after such date.

The Commissioner says that if there were no exercisable options at the time of discharge, the act of an employer in allowing a discharged employee to exercise options which would have accrued subsequent to such discharge constitutes a modification. The Commissioner's position is contrary to his own ruling, Revenue Ruling 70-94 (1970-1 C.B. 112) which permits the estate of a deceased employee to exercise options to a number greater than the number which was available for exercise by the deceased employee. The Commissioner's position finds no warrant in Section 425(h)(3)(C) of the Code or its legislative history (see our principal brief, p. 29).

Logan's argument says that notwithstanding Section 425(h)(3)(C), and its express reference and applicability to restricted stock options under Section 424, an acceleration of a restricted stock option constitutes a modification and is equivalent to the grant of a new option. As support for this proposition Logan refers to Section 1.421-4 of Treasury Regulations (Logan's Brief, p. 18). What Logan fails to apprehend is that Section 421-4 of the Regulations is applicable to

Section 421 of the Code as it existed before its amendment by Section 221 of the Revenue Act of 1964 (see Regulations 1.421-1(g)). And see Regulations 1.425-1(e) which are explicitly applicable to changes (which are or are not the equivalent of modifications of an option) made in taxable years of optionee's beginning after December 31, 1963. And see, as specifically applicable here, Regulations 1.425-1(e)(5)(iii).

Thus, any acceleration by Logan of Guild's option rights did not constitute a modification under Section 425(h) of the Code.

III.

THE EFFECT OF THE RESTRICTIONS ON TRANSFERABILITY IMPOSED BY LOGAN.

We contended in our principal brief (p. 37, et. seq.) that since the Tax Courts' decided that Guild's receipt of the Logan stock was not in pursuance of his exercise of an option under the Stock Option Agreement, the Settlement Agreement had to have been read by the Court in consonance with the Commissioner's and Logan's post-trial brief contentions that its language* made the Securities Act transfer restrictions of the Stock Option agreement applicable to the shares which

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* "We do hereby recognize your right to 6,500 shares of our stock upon the terms and conditions of the option".

Guild received. We said further that if such were the case, the restrictions had a significant effect upon the value of the shares transferred to Guild so that, under any circumstances, there could be no realization of income by Guild at the time of the transfer, and that the Tax Court erred in denying Guild's post-opinion motions which sought the opportunity to establish the validity of such position.

In opposition to these contentions the Commissioner and Logan point to the Stipulation of Facts (62a) in which the parties stipulated that the fair market value of Logan stock on November 20, 1967, the date of Guild's purchase of Logan stock, was $54.50. However, the parties nowhere agreed that the 6,500 Logan shares purchased by Guild were worth $54.50 per share. Obviously, if Guild's shares were not freely marketable they were not worth the price of freely marketable shares.

The fact that this argument was not raised until after the conclusion of the trial is of no consequence since it was raised before the entry of the Tax Court's decision, and in view of the fact that the Securities Act transfer restrictions argument of the Commissioner and Logan were first raised after trial, it was an abuse of the Tax Court's discretion to deny to Guild the opportunity to prove that such restrictions would have a significant effect upon the value of the Logan stock.

The Commissioner, in an effort to deprecate Guild's position, points to the fact that Guild was not an insider when he purchased the stock as rendering "the merit of his claim of restriction highly doubtful" (Comm.'s Brief, p. 31). One need not be an insider to be prohibited from effecting a distribution of securities in the absence of registration under the Securities Act (see Securities Act of 1933, Section 5).

CONCLUSION

The decision of the Tax Court should be reversed.

Respectfully submitted,

BRAUNER BARON ROSENZWEIG KLIGLER & SPARBER
Attorneys for Appellants Guild

Elias Rosenzweig
Stanley M. Klein
Martin B. Farber
Attorneys

APPENDIX

INTERNAL REVENUE CODE SECTION
SECTION 421(e) BEFORE ITS AMEND-
MENT BY SECTION 221 OF THE REVENUE
ACT OF 1964

(e) MODIFICATION, EXTENSION, OR RENEWAL OF OPTION.—

(1) RULES OF APPLICATION.—For purposes of subsection (d), if the terms of any option to purchase stock are modified, extended, or renewed, the following rules shall be applied with respect to transfers of stock made on the exercise of the option after the making of such modification, extension, or renewal—

(A) such modification, extension, or renewal shall be considered as the granting of a new option,

(B) the fair market value of such stock at the time of the granting of such option shall be considered as—

(i) the fair market value of such stock on the date of the original granting of the option,

(ii) the fair market value of such stock on the date of the making of such modification, extension, or renewal, or

(iii) the fair market value of such stock at the time of the making of any intervening modification, extension, or renewal,

whichever is the highest.

Subparagraph (B) shall not apply if the aggregate of the monthly average fair market values of the stock subject to the option for the 12 consecutive calendar months before the date of the modification, extension, or renewal, divided by 12, is an amount less than 80 percent of the fair market value of such stock on the date of the original granting of the option or the date of the making of any intervening modification, extension, or renewal, whichever is the highest.

(2) DEFINITION OF MODIFICATION.—The term "modification" means any change in the terms of the option which gives the employee additional benefits under the option, but such terms shall not include a change in the terms of the option—

(A) attributable to the issuance or assumption of an option under subsection (g); or

(B) to permit the option to qualify under subsection (d) (1) (B).

If an option is exercisable after the expiration of 10 years from the date such option is granted, subparagraph (B) shall not apply unless the terms of the option are also changed to make it not exercisable after the expiration of such period.

REGULATION SECTION 1.425-1(e)

(e) **Modification, extension, or renewal of option.** (1) Section 425(h) provides the rules for determining whether a share of stock transferred to an individual upon his exercise of an option, after the terms thereof have been modified, extended, or renewed, is transferred pursuant to the exercise of a statutory option. Such rules and the rules of this section are applicable to modifications, extensions, or renewals (or to changes which are not treated as modifications) of an option in any taxable year of the optionee which begins after December 31, 1963, except that section 425(h)(1) and this paragraph shall not apply to any change made before January 1, 1965, in the terms of an option granted after December 31, 1963, to permit such option to meet the requirements of section 422(b)(3), (4), or (5), and the regulations thereunder. See paragraphs (d), (e), and (f), of §1.422-2, relating to period for exercising options, option price, and prior outstanding options, respectively, in the case of qualified stock options.

(2) Any modification, extension, or renewal of the terms of an option to purchase stock shall be considered as the granting of a new option.

(3) Except as otherwise provided in subparagraph (4) of this paragraph, in case of a modification, extension, or renewal of an option, the highest of the following values shall be considered to be the fair market value of the stock at the time of the granting of such option for purposes of applying the rules of sections 423(b)(6), and 424(b)(1)—

(i) The fair market value on the date of the original granting of the option,

(ii) The fair market value on the date of the making of such modification, extension, or renewal, or

(iii) The fair market value at the time of the making of any intervening modification, extension, or renewal.

(4) (i) In the case of a modification, extension, or renewal of a restricted stock option before January 1, 1964 (or after December 31, 1963, if made pursuant to a binding written contract entered into before January 1, 1964), the rules of subparagraph (3) of this paragraph do not apply if the aggregate of the monthly average fair market values of the stock subject to the option for the 12 consecutive calendar months preceding the month in which the modification, extension, or renewal occurs, divided by 12, is an amount less than 80 percent of the fair market value of such stock on the date of the original granting of the option or the date of the making of any intervening modification, extension, or renewal, whichever is the highest. In such case, any modification, extension, or renewal of the option is treated as the granting of a new option but only the fair market value of the stock subject to the option at the time of the modification, extension, or renewal is considered in determining whether the option is a restricted stock option. In the case of stocks listed on a stock exchange, the average fair market value of the stock for any month may be determined by adding the highest and lowest quoted selling prices during such month and dividing the sum by two. The method used for determining the average fair market value of the stock for any month must be used for all twelve months, except where it is shown that such method cannot be used for any month or does not clearly reflect the average fair market value of the stock for any such month.

(ii) The application of subdivision (i) of this subparagraph may be illustrated by the following example:

Example. On June 1, 1962, a restricted stock option was granted to purchase before July 1, 1965, a share of stock for $85. The fair market value of such stock on June 1, 1962, was $100. On June 15, 1963, when the fair market value of the stock is $60, such

option is extended so that it is exercisable at any time before July 1, 1966, at $55 a share. The average fair market value of the stock subject to the option for each of the 12 calendar months preceding June 1963, is as follows:

1962		1963	
June	$100	January	$ 90
July	90	February	80
August	80	March	70
September	70	April	60
October	80	May	60
November	80		
December	90		

The aggregate of such values is $950. When this sum is divided by 12, the result is $79.17, which is an amount less than 80 percent of the fair market value of the stock ($100) when the option was granted. Accordingly, when the option is extended on June 15, 1963, the option price could have been reduced as low as $51 (85 percent of the fair market value of the stock on such day) without disqualifying the option as a restricted stock option. If the aggregate fair market values of the stock so ascertained had amounted to $960 or more, the rules of subparagraph (3) of this paragraph would have been applicable with the result that any reduction in the option price would have disqualified the option as a restricted stock option.

(5) (i) The time or date when an option is modified, extended, or renewed shall be determined, insofar as applicable, in accordance with the rules governing determination of the time or date of granting an option provided in paragraph (c) of §1.421-7. For purposes of sections 421 through 425, the term "modification" means any change in the terms of the option which gives the optionee additional benefits under the option. For example, a change in the terms of the option, which shortens the period during which the option is exercisable, is not a modification. However, a change which provides more favorable terms for the payment for the stock purchased under the option, is a modification. Where an option is amended solely to increase the number of shares subject to the option, such increase shall not be considered as a modification of the option, but shall be treated as the grant of a new option for the additional shares.

(ii) (a) A change in the number or price of the shares of stock subject to an option merely to reflect a stock dividend, or stock split-up, is not a modification of the option.

(b) A change in the number or price of the shares of stock subject to an option to reflect a corporate transaction (as defined by paragraph (a)(1)(ii) of this section) is not a modification of the option provided that the excess of the aggregate fair market value (determined immediately after such corporate transaction) of the shares subject to the option immediately after such change over the aggregate new option price of such shares is not more than the excess of the aggregate fair market value of the shares subject to the option immediately before the transaction over the aggregate former option price of such shares, and provided that the option after such change does not give the employee additional benefits which he did not have before such change. The ratio of the option price immediately after the change to the fair market value of the stock subject to the option immediately after the corporate transaction must not be more favorable to the optionee on a share by share comparison than the ratio of the old option price to the fair market value of the stock subject to the option immediately before such transaction. A reduction in the option price of an option, other than as specifically provided for in this section, is a modification of such option.

(c) The application of (b) of this subdivision may be illustrated by the following example:

Example. E, an employee of P Corporation, holds a qualified stock option granted to him by P to buy 90 shares of P stock at $36 per share. P Corporation is a party to a corporate transaction (as defined by paragraph (a)(1)(ii) of this section) which results in a decline in the fair market value of P stock. Immediately before such transaction the fair

Reg. §1.425-1(e)(5)(ii)(c) Example continued

market value of P stock was $64 per share. Immediately after such transaction, the fair market value of P stock is $48 per share. Two weeks after such transaction, P proposes to amend E's option in order to reflect the decline in the fair market value of P stock attributable to the transaction. At such time, the fair market value of P stock is $50 per share. However, since the change was not made at the time of the transaction, the fair market value of P stock at the time of the change is irrelevant for purposes of determining whether the change comes under the rule of (b) of this subdivision. P changes the terms of E's option to lower the option price to $27 per share and to increase the number of shares subject to the option to 120. No other terms of the option are changed. The aggregate fair market value (determined immediately after the corporate transaction) of the shares subject to the option immediately after the change is $5,760 ($48 × $120). The aggregate option price of the shares subject to the option immediately after the change is $3,240 ($27 × 120). Thus, the excess of such fair market value over such option price is $2,520 ($5,760 — $3,240). The aggregate fair market value of the stock subject to the option immediately before the corporate transaction is $5,760 ($64 × 90). The aggregate option price for the stock subject to the option immediately before the change is $3,240 ($36 × 90). Thus, the excess of such fair market value over such option price is $2,520 ($5,760 — $3,240). Accordingly, the excess after the change does not exceed the excess before the corporate transaction. Moreover, the ratio of the option price immediately after the change ($27 per share) to the fair market value of P stock immediately after the transaction ($48 per share) is not more favorable to E on a share by share comparison than the ratio of the old option price ($36 per share) to the fair market value of P stock immediately before the transaction ($64) (27/48 = 36/64). For purposes of section 425(h), the changes made do not confer additional benefits on E which he did not have before the change. Accordingly, the changes do not constitute a modification of E's option.

(iii) Any change in the terms of an option for the purpose of qualifying the option as a statutory option grants additional benefits and, therefore, is a modification. However, if the terms of an option are changed to provide that the optionee cannot transfer the option except by will or by the laws of descent and distribution in order to meet the requirements of section 422(b)(6), 423(b)(9), or 424(b)(2), such change is not a modification, provided that in any case where the purpose of the change is to meet the requirements of section 424(b)(2) the option is at the same time changed so that it is not exercisable after the expiration of ten years from the date the option was granted. Where an option is not immediately exercisable in full, a change in the terms of such option to accelerate the time at which the option (or any portion thereof) may be exercised is not a modification for purposes of section 425(h) and this section. A modification results where an option is revised to insert the language required by section 422(c)(6)(B).

(iv) An extension of an option refers to the granting by the corporation to the optionee of an additional period of time within which to exercise the option beyond the time originally prescribed. A renewal of an option is the granting by the corporation of the same rights or privileges contained in the original option on the same terms and conditions. The rules of this paragraph apply as well to successive modifications, extensions, and renewals.

(6) A statutory option may, as a result of a modification, extension, or renewal, thereafter cease to be a statutory option, or any option may, by modification, extension, or renewal, thereafter become a statutory option. Moreover, a qualified option after a modification may not be exercisable in accordance with its terms because of the requirements of section 422(b)(5) and section 422(c)(6). See paragraph (f)(3)(i) of §1.422-2 and examples (8) and (9) of paragraph (f)(4) of §1.422-2.

(7) The application of this paragraph may be illustrated by the following examples:

Example (1). On June 1, 1964, the X Corporation grants to an employee an option under X's employee stock purchase plan to purchase 100 shares of the stock of X Corporation at $90 per share, such option to be exercised on or before June 1, 1966. At the time the option is granted, the fair market value of the X Corporation stock is $100 per share. On February 1, 1965, before the employee exercises the option, X Corporation

Reg. §1.425-1(e)(7)Example (1) continued

modifies the option to provide that the price at which the employee may purchase the stock shall be $80 per share. On February 1, 1965, the fair market value of the X Corporation stock is $90 per share. Under section 425(h), the X Corporation is deemed to have granted an option to the employee on February 1, 1965. Such option shall be treated as an option to purchase at $80 per share 100 shares of stock having a fair market value of $100 per share, that is, the higher of the fair market value of the stock on June 1, 1964, or on February 1, 1965. The exercise of such option by the employee after February 1, 1965, is not the exercise of a statutory option.

Example (2). On June 1, 1964, the X Corporation grants to an employee an option under X's employee stock purchase plan to purchase 100 shares of X Corporation stock at $90 per share, exercisable after December 31, 1965, and on or before June 1, 1966. On June 1, 1964, the fair market value of X Corporation's stock is $100 per share. On February 1, 1965, X Corporation modifies the option to provide that the option shall be exercisable on or before September 1, 1966. On February 1, 1965, the fair market value of X Corporation stock is $110 per share. Under section 425(h), X Corporation is deemed to have granted an option to the employee on February 1, 1965, to purchase at $90 per share 100 shares of stock having a fair market value of $110 per share, that is, the higher of the fair market value of the stock on June 1, 1964, or on February 1, 1965. The exercise of such option by the employee is not the exercise of a statutory option.

Example (3). The facts are the same as in example (1), except that the employee exercised the option to the extent of 50 shares on January 15, 1965, before the date of the modification of the option. Any exercise of the option after February 1, 1965, the date of the modification, is not the exercise of a statutory option. See example (1) in this subparagraph. The exercise of the option on January 15, 1965, pursuant to which 50 shares were acquired, is the exercise of a statutory option.

Example (4). On June 1, 1964, the X Corporation grants to an employee an option to purchase 100 shares of the stock of X Corporation at $80 per share, such option to be exercised on or before June 1, 1966. At the time the option is granted, the fair market value of the X Corporation stock is $100 per share. On February 1, 1965, before the employee exercises the option, the X Corporation modifies the option to provide that the number of shares of stock which the employee may purchase at $80 per share will be 250. On February 1, 1965, the fair market value of X Corporation stock is $80 per share. Under these facts, the X Corporation has granted two options, one option (not a statutory option) with respect to 100 shares having been granted on June 1, 1964, and the other option (a qualified stock option) with respect to the additional 150 shares having been granted on February 1, 1965. In the absence of facts identifying which option is exercised first, the employee will be deemed to have exercised the options in the order in which they were granted.

PROHIBITIONS RELATING TO INTERSTATE COMMERCE AND THE MAILS

¶ 4831 [Requirement for Registration of Securities]

Sec. 5. (a) Unless a registration statement is in effect as to a security, it shall be unlawful for any person, directly or indirectly—

(1) to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to sell such security through the use or medium of any prospectus or otherwise; or

(2) to carry or cause to be carried through the mails or in interstate commerce, by any means or instruments of transportation, any such security for the purpose of sale or for delivery after sale.

¶ 4832 [Prospectus Requirements]

Sec. 5. * * * (b) It shall be unlawful for any person, directly or indirectly—

(1) to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to carry or transmit any prospectus relating to any security with respect to which a registration statement has been filed under this title, unless such prospectus meets the requirements of section 10; or

(2) to carry or to cause to be carried through the mails or in interstate commerce any such security for the purpose of sale or for delivery after sale, unless accompanied or preceded by a prospectus that meets the requirements of subsection (a) of section 10.

¶ 4833 [Prohibition Against "Offers" Prior to Filing of Registration]

Sec. 5. * * * (c) It shall be unlawful for any person, directly or indirectly, to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to offer to sell or offer to buy through the use or medium of any prospectus or otherwise any security, unless a registration statement has been filed as to such security, or while the registration statement is the subject of a refusal order or stop order or (prior to the effective date of the registration statement) any public proceeding or examination under section 8.

[Sec. 5 as amended by Acts of June 6, 1934 and August 10, 1954; 15 U. S. Code 77e.]

CERTIFICATE OF SERVICE

It is hereby certified that service of this brief has been made on opposing counsel, by mailing four copies thereof to each on this 10th day of February, 1976, in envelopes, with postage prepaid, properly addressed to each of them, respectively, as follows:

GILBERT E. ANDREWS, ESQ.
Tax Division
Department of Justice
Washington, D.C. 20530

STEPHEN D. GARDNER, ESQ.
Kronish, Lieb, Shainswit,
Weiner & Hellman
1345 Avenue of the Americas
New York, New York 10019

Elias Rosenzweig

ELIAS ROSENZWEIG
Attorney